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## The Announcement Effect of Equity Private Placement: Evidence from Malaysia

Norhafiza Nordin<sup>1</sup>, Norlida Abdul Manab<sup>2</sup> and Zaemah Zainudddin<sup>3</sup>

<sup>1-3</sup>*School of Economics, Finance and Banking, College of Business, Universiti Utara Malaysia, Malaysia. Email: <sup>1</sup>[norhafiza@uum.edu.my](mailto:norhafiza@uum.edu.my)*

### ABSTRACT

This study examines the Malaysian stock market reaction to the announcement of equity private placement made by 127 publicly listed firms for the period from 2013 to 2015. Using standard event study methodology, the results for different event windows show zero announcement effect in response to the announcements. The finding is inconsistent with majority of past studies' results which indicate positive announcement effect. Thus, it can be concluded that the market is indifferent to the announcement of private placement and both hypotheses cannot be applied to explain the announcement effect of equity private placement in Malaysia.

**JEL Classification Codes:** A11, C12.

**Keywords:** Private placement; announcement effect; monitoring hypothesis; information asymmetry hypothesis.

### 1. INTRODUCTION

A report by Securities Commission (SC) shows that the Malaysian capital market grew to RM2.82 trillion for the year 2015 amidst global uncertainties. The figure was equivalent to 2.5 times the country's economy. In 2014, the value of Malaysian capital market was 2.76 trillion. In particular, a total of RM1.70 trillion was raised in the equity market. The figure reflects an increment of 2.6 percent from RM1.65 trillion raised in 2014. Approximately RM90 billion was obtained from the primary market while RM17 billion was obtained from the secondary equity market. These figures show that the capital market continues to be an important source of financing in Malaysia. Private placement is one of the financing alternatives used by firms in Malaysia.

Private placement of equity is defined as issuance of new shares to a limited number of individual investors or companies. Usually, it involves issuance of securities to selected institutional investors or high net worth individuals. The Securities Commission (SC) of Malaysia formally defines private placement as a security marketed to specified persons. As it involves a small number of parties, it offers a fast and easier way to raise funds. Unlike public placement, private placement permits the investors to have direct negotiations with the issuers. Hence, give them the opportunity to have the access to the firm's private information. Consequently, when these investors agree to purchase the shares, the market perceives the act as a good signal about the shares' value (Hertzel & Smith, 1993).

The use of private placement as a financing alternative in Malaysia started to get the firms' attention in 1994. That was the year when Securities Commission of Malaysia announced a less stringent set of regulations that made issuance of private placement much simpler compared to other methods of raising capital. As a result, the time takes to raise capital using private placement is usually less than the time takes to raise capital using other methods. For that reason, many firms (as stated in their circulars to shareholders) choose private placement to seek for short-term funding such as working capital funding.

Past studies (see for example, Wruck, 1989; Hertzel & Smith, 1993; Wruck & Wu, 2009; Chen et. al., 2010; Shiu and Wei, 2013; Cheng, Wang & Chen, 2014; Yeh, Shu & Kao, 2015; Chen et. al., 2016) show significantly positive abnormal returns in conjunction to the announcement of private placement. Two prominent hypotheses that have been used to explain the positive stock price performance are monitoring hypothesis (Wruck, 1989) and information hypothesis (Hertzel & Smith, 1993). Wruck (1989) posits that private placements result in ownership concentration which in turn decreases the agency cost. While, Hertzel and Smith (1993) assert that private placements help to convey firm's inside information to the market. Essentially, when an informed private placement investor would like to purchase the shares, a favorable sign is communicated to the market that the shares are worth to buy.

## **2. LITERATURE REVIEW**

Extant literature documents negative announcement effect of public equity offerings (see for example, Myers & Majluf, 1984; Asquith & Mullins, 1986; Masulis & Korwar, 1986; Mikkelsen & Partch, 1986; Baker & Wurgler, 2002). On the contrary, past studies on private equity offerings give opposite evidence. Extant literature shows that market reacts positively to the announcement of private equity offerings. The studies include those by Wruck (1989), Hertzel and Smith (1993), Kato and Schallheim (1993), Molin (1996), Hertzel and Rees (1998), Ferreira and Brooks (1999), Goh et. al., (1999), Hertzel et. al., (2002), Tan et. al., (2002), Folta and Janney (2004), Brooks and Graham (2005), Cronqvist and Nilsson (2005), Krishnamurthy et. al., (2005), Wruck and Wu (2009), Chen et. al., (2010), Shiu and Wei (2013), Cheng et. al., (2014), Yeh et. al., (2015), and Chen et. al., (2016). Nevertheless, study by Tuli and Shukla (2015) in Indian capital market reveals negative stock market reaction to the announcement of private placement.

Most of the studies on the announcement effect of private placements are done in the United States. Wruck (1989), for example, reports positive announcement returns of 4.4 percent for 99 private placements made by firms listed on New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) for the period from 1979 to 1985. The positive returns reflect the reduction of agency cost and increase of monitoring service provided by the investors. A study by Hertzel and Smith (1993) also reveals positive announcement effect (1.7 percent) using a sample of 106 firms announcing the issuance of private placements

from 1980 to 1987. They reason that the positive effect is due to the favorable information conveyed about the firm. Other studies that have been carried out in the United States include those by Hertznel and Rees (1998), Ferreira and Brooks (1999), Goh et. al., (1999), Hertznel et. al., (2002), and Wruck and Wu (2009). Their studies indicate significant positive returns of 1.3 percent, 3.0 percent, 2.4 percent, 2.4 percent, and 2.0 percent respectively. Similar results are observed by Krishnamurthy et. al., (2005), Brooks and Graham (2005) and Chen et. al., (2010). Specifically, Krishnamurthy et. al., (2005) find positive returns of 2.2 percent for 397 firms placing equity private placements between 1983 and 1992. Brooks and Graham (2005) observe abnormal returns of 2.5 percent, and Chen et. al., (2010) report four-day (-3,0) cumulative abnormal returns (CARs) of 3.41 percent for 288 firms listed on NYSE, AMEX, and NASDAQ from 1997 to 2003.

Elsewhere, comparable outcomes are presented by Kato and Schallheim (1993) and Molin (1996). In Japan, Kato and Schallheim (1993) find a significant 5 percent of abnormal returns surrounding the announcement dates of private placements made during 1974 to 1988. Correspondingly, Molin (1996) examines 76 private placements by firms listed on Stockholm Stock Exchange and reports positive announcement returns of 3.21 percent. Also in Sweden, similar result is observed by Cronqvist and Nilsson (2005). Three-day cumulative abnormal returns (CARs) of 7.3 percent are recorded for 136 firms issuing equity private placement during 1986 and 1999. In Singapore, Tan et. al., (2002), find positive announcement effects of private placements issued from 1987 to 1996. In particular, the abnormal returns are positively correlated to the issuance price. A more recent study by Chen et. al., (2016) finds positive abnormal returns for 657 equity private placement announcements, during the period between 2005 and 2013, made by firms in Taiwan. They attribute the positive results to the long-term strategic alliance and business integration formed. In addition, the findings also indicate that the positive returns are realized when the lead investor is from the same industry.

One of the justifications used to illustrate the positive announcement returns is the increase in monitoring services which consequently reduce the firm's agency cost. In essence, monitoring, agency cost, and managerial entrenchment are three theories that have been used to describe the stock price reaction to the issuance of equity private placements. Evidence from past studies shows private placements help to reduce agency cost. This is because private placement buyers are assumed to be well informed or very knowledgeable about the firm. Hence, their willingness to purchase the shares indicate positive hint about their value (Hertznel & Smith, 1993). In addition, they are also able to offer expert advice and monitoring services. Wruck (1989) claims that private placements increase a firm's value by increasing ownership concentration. This is because ownership concentration results in better monitoring services which then may reduce the firm's agency cost. On the one hand, change in ownership concentration helps to solve the agency cost problem. On the other hand, it may also promote managerial entrenchment which can decrease the firm's value. Hertznel and Smith (1993) support the findings of earlier studies. Their findings reveal that private placements act as an efficient monitoring mechanism on the condition that the management team does not involve with the transaction. In contrast, Shiu and Wei (2013) find that firms experience better post-issue stock and operating performance when the shares are issued to owner-managers or nonexecutive directors. Hence, their findings suggest that an increase in insiders' stakes leads to better arrangement of managerial incentives and an increase in monitoring. Correspondingly, Ferreira and Brooks (1999) find a positive relationship between ownership concentration and abnormal returns. The positive effect is the result of increase monitoring due to higher ownership concentration.

In addition to monitoring hypothesis, the positive market reaction is also triggered by the ability of private placement to curb problems arising from information asymmetry (Hertzel & Smith, 1993; Hertzel & Rees, 1998; and Goh et. al., 1999; Lee & Kocher, 2001; Wu, 2004; Cronqvist & Nilsson, 2005). Information asymmetry which usually exists between managers and investors regarding the firm's true value may cause the deal to go awry. This is because the public believe that managers with better information will always act in the best interest of current shareholders (Myers & Majluf, 1984). Therefore, there is a high possibility that these managers issue overvalued shares to the public. This proposition has been supported by evidence that reveals managers of firms with high asymmetric information tend to use equity financing and time the stock issuance when the stock prices are high (Ritter, 1991; Dittmar & Thakor, 2007). Frequently, in order to avoid the negative signal, managers of undervalued firms are reluctant to issue new equity even though they have profitable investment opportunities. Private placement provides a solution to this problem. Previous studies indicate that firms with high information asymmetry choose private placement over public placement as the investors are more privy to the firm's information and true value (Hertzel & Smith, 1993; Hertzel & Rees, 1998; and Goh et. al., 1999; Lee & Kocher, 2001; Wu, 2004; Cronqvist & Nilsson, 2005). The willingness of the investors to purchase the shares signals to the market that the stock is undervalued, thus alleviating the under investment problem proposed by Myers and Majluf (1984). Hertzel and Rees (1998) posit positive relationship between earnings changes and announcement returns. Goh et. al., (1999) find positive relationship between abnormal returns and analysts upward revisions of earnings forecasts. These findings reflect the favorable information about the good potential earnings prospects of the firm. Folta and Janney (2004) provide evidence that private placements benefit the issuing firms by reducing the threats associated with information asymmetry. Brooks and Graham (2005) claim that private placement investors help to increase firm's liquidity. This gives benefits especially to small firms with less financial slack. The enhancement of firms' liquid assets results in positive return to the firms. Relatedly, Ferreira and Brooks (1999) assert that the positive returns are influenced by investors' anticipations about the firms' future prospect. Hertzel et. al., (2002) claim the announcement effect is caused by the investors' overoptimism or overconfident that the firm's poor performance will be better off with the private offerings. Evidence from their study shows that firms usually choose equity offerings when the firm's operating performance is poor. Similarly, Anderson (2006) observes that the issuing firms experience negative earnings and have extreme values of book-to-market equity ratio before the private placement announcements.

A study by Cheng et. al., (2014) reveals that the stock performance of private equity placements is significantly affected by the investment horizon of the institutional shareholders. Specifically, significant positive abnormal returns are observed for firms with long-term institutional investors. This finding reflects the monitoring services that these shareholders offer which reduce the information asymmetry and thus, increase the firm's value. Yeh et. al., (2015) assert that the positive announcement effect is due to good governance practiced by the firms. The findings of their study indicate that the announcement effect for good corporate governance firms is significantly higher than the bad governance firms. Inconsistent with majority of the previous studies findings, a study conducted by Tuli and Shukla (2015) finds that the Indian stock market reacts negatively to the announcement of private placements. In India, private placements can be classified into two (1) preferential allotment and (2) qualified institutional placement or commonly known as QIP. The latter which has been in existence recently is said to be more cost effective and quicker to implement. For that reason more companies choose to issue QIP compared to preferential allotment (Tuli & Shukla, 2015). The study by Tuli and Shukla (2015) is based on the QIP announcements made by

150 companies listed on Bombay Stock Exchange (BSE) for the period from 2006 to 2012. The conclusion drawn is that the negative response is due to weak Indian capital market regulations.

In conclusion, majority of the past studies show firms that issue private placements experience positive announcement effects. The positive effects are usually explained using monitoring effect and information effect.

### 3. DATA AND METHODOLOGY

The objective of this study is to examine the announcement effect or to measure the changes in shareholder wealth around the announcement of private placement. Accordingly, using the standard event study methodology, we test the hypothesis which states that H1: the abnormal returns surrounding the announcement date are statistically significantly different from zero. Among the studies that have used this technique include Wruck (1989), Hertz and Smith (1993), Folta and Janney (2004), Cheng et. al., (2014), Yeh et. al., (2015), Tuli and Shukla (2015) and Chen et. al., (2016). The sample consists of all public listed firms (excluding finance and finance related firms) that announced private placements issuance from the year 2013 to 2015. These firms are listed either on the Main Market or ACE Market of Bursa Malaysia. The initial sample is obtained by gathering the announcements of the equity private placements published on Bursa Malaysia's website. The event date refers to the date when the first authorized announcement is made known to the public. Only "clean" announcements are included. Announcement of private placements together with other announcements are omitted in order to avoid confounding effect or multiple effect. Daily share prices, monthly share prices, and market index prices are gathered from the Data Stream database. Excluding firms with incomplete data, the final sample consists of 127 announcements.

To be able to examine the periods surrounding the event, an event window of 81 days which comprised of 60 pre-event days, the event day, and 20 post-event days are adopted. After that, the abnormal return is calculated. The abnormal return is the difference between the actual return and the expected return or simply the excess return of a stock (Corrado, 2011). This can be illustrated by the equation below:

$$AR_{it} = R_{it} - E(R_{it} | X_t)$$

where,

$AR_{it}$  = the abnormal return for firm  $i$  on day  $t$ ,

$R_{it}$  = the actual return for firm  $i$  on day  $t$ ,

$E(R_{it} | X_t)$  = the normal return for firm  $i$  on day  $t$ .  $X_t$  refers to the conditioning information for the normal return model.

The actual returns are calculated as follow:

$$R_{it} = \text{LN}(P_{it}/P_{it-1})$$

where,

$R_{it}$  = the actual return for firm  $i$  on day  $t$ ,

$\text{LN}(P_{it}/P_{it-1})$  = the natural log of stock price for firm  $i$  on day  $t$  divided with the stock price for firm  $i$  on the day before.



In order to calculate the abnormal return, normal return must first be determined. This study adopts market model to calculate normal return because of its ability to increase the power of the statistical test by reducing the variance of the performance measures. In particular, it reduces the variance of the abnormal return by eliminating the portion of the return that is related to variation in the market's return. The higher the  $R^2$ , the greater the reduction in the variation of the abnormal returns (MacKinlay, 1997). Among past studies that use market model include Molin (1996), Hertz and Rees (1998), Tan et. al., (2002), Krishnamurthy et. al., (2005), Wruck and Wu (2009), Tuli and Shukla (2015) and Chen et. al., (2016). The equation for calculating normal returns using market model is as follow:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

where,

$R_{it}$  = the period- $t$  return of firm  $i$  on day  $t$ ,

$R_{mt}$  = the period- $t$  return of market portfolio on day  $t$ ,

$\varepsilon_{it}$  = the zero mean disturbance term,

$\alpha_i$  and  $\beta_i$  = the parameters of the model.

The parameters,  $\alpha_i$  and  $\beta_i$  are derived using ordinary least squares (OLS) method. The estimation period for the market model parameters is 140 days. In particular the period starts from day -200 to day -61. A long period of estimation window can eliminate the additional variance caused by the sampling error in  $\alpha_i$  and  $\beta_i$  (MacKinlay, 1997). Tuli and Shukla (2015) use estimation period of 120 days, Wruck and Wu (2009) use 250 days, Tan et. al., (2002) use 140 days and Molin (1996) uses 180 days.

To observe the cumulative effect of the announcement over the specified period and to draw overall inferences, the abnormal returns are then being aggregated. The cumulative abnormal returns of firm  $i$  (CAR $_i$ ) over the specified period  $T$  are calculated by summing daily abnormal returns of firm  $i$  across time, as follow:

where,

CAR $_i(\tau_1, \tau_2)$  = the cumulative abnormal returns of firm  $i$  over the specified period  $T$ ,

$\sum_{\tau=\tau_1}^{\tau_2} AR_{i\tau}$  = the summation of abnormal returns for firm  $i$  over the specified period  $T$ .

Finally, the abnormal returns must be examined to determine whether, on average, the announcements have significantly affected the share prices or there has been any market reaction to the announcements. The following  $t$ -statistics is used to test the null hypothesis that the cumulative average abnormal returns (CAAR $_i$ ) over the specified period  $T$  is equal to zero. In other words, to examine whether the private placement announcements have an impact or not on the share prices.

$$\theta_1 = \frac{CAAR(\tau_1, \tau_2)}{\text{var}(CAAR(\tau_1, \tau_2))^{1/2}} \sim N(0, 1)$$

where,

$$CAAR(\tau_1, \tau_2) = \sum_{\tau=\tau_1}^{\tau_2} AAR_{\tau}$$

$$AAR_{\tau} = \sum_{i=1}^n AR_{it} / n$$

and

$$\text{var}(CAAR(\tau_1, \tau_2)) = \sum_{\tau=\tau_1}^{\tau_2} \text{var}(AAR_{\tau})$$

where for large estimation window, the variance is,

$$\text{var}(AAR_{\tau}) = \frac{1}{N^2} \sum_{\tau=1}^N \sigma_{\epsilon i}^2$$

where,  $\sigma_{\epsilon i}^2$  is the residual variance from the market model's regression.

Based on the rule that only two percent of the new private placement equity can be issued to one investor, it is expected that private placement in Malaysia will not result in positive announcement effect as it does in other countries. Due to the limitation imposed, the issuance of equity private placements may not be able to increase monitoring and provide better governance. In other words, private placement in Malaysia will not be able to create block holders who can actively monitor and control the issuing firms. Consequently, the impact and effectiveness of private placement as a monitoring mechanism will not be experienced as what have been observed in past studies conducted elsewhere.

#### 4. FINDINGS AND DISCUSSIONS

The initial number of announcements gathered are 242. The announcements are made by firms listed on both the Main Market and ACE Market of Bursa Malaysia. Nevertheless, only 135 of them are clean announcements (refer to Table 1). The final sample consists of 127 announcements as eight announcements have to be excluded due to unavailable data. Out of these 127 announcements, 90 announcements or more than 70 percent are the announcements made by firms listed on the Main Market. Less than 30 percent of the announcements are made by those listed on the ACE Market. Table 2 presents the distribution of the sample by sector and Table 3 presents the distribution of the sample by year. It is shown that more than 50 percent of the announcements come from firms in the technology and trading or services sectors. The highest number of announcements is recorded for the year 2013 while year 2014 has the lowest number of announcements.

**Table 1**  
**Private Placement Announcement Sample**

<i>Description</i>	<i>Number</i>
Initial announcements (Main Market and ACE Market)	242
Initial announcements (Main Market)	167
Initial announcements (ACE Market)	75
Clean announcements (Main Market and ACE Market)	135
Clean announcements (Main Market)	90
Clean announcements (ACE Market)	45

**Table 2**  
**Private Placement Announcements by Sector**

<i>Sector</i>	<i>Number of Clean Announcement</i>
Construction	8
Consumer	11
Industrial Product	33
Infrastructure Project Company	1
Plantation	4
Properties	6
Technology	36
Trading/Services	36
Total	135

**Table 3**  
**Private Placement Announcements by Year**

<i>Year</i>	<i>Number of Clean Announcement</i>
2013	51
2014	39
2015	45
Total	135

Table 4 presents the average abnormal return (AAR) on and the period surrounding the announcement date. The results indicate that the AARs are not significant. The returns on the announcement date and also for days from  $t = -5$  to  $t = 5$  are not statistically significantly different from zero. This means the private placement announcements have no effect on the share prices and the shareholder wealth. In general, the results do not support the findings of past studies, such as Wruck (1989), Hertz and Smith (1993), Folta and Janney (2004), Wruck and Wu (2009), Chen et. al., (2010), Shiu and Wei (2013), Cheng et. al., (2014), Yeh et. al., (2015) and Chen et. al., (2016), that find positive stock price reaction in response to the announcement of private placement issuance. The findings are inconsistent with findings of extant literature which suggest private placement result in better monitoring services and certification of firm's fair value. In other words, the findings suggest that the investors are unable to monitor and control the management in order to make sure the firm's resources are used more efficiently. In addition, the investors also fail to provide the certification effect of firm's true value by agreeing to purchase the stock.

**Table 4**  
**Average Abnormal Returns (AARs)**  
**Over Eleven-Day Period**

<i>Day</i>	<i>AAR (%)</i>	<i>p-value</i>
-5	-0.51	0.95861
-4	-0.13	0.95965
-3	0.26	0.95759
-2	0.50	0.95357
-1	-0.20	0.95518



0	0.56	0.95076
1	0.04	0.95043
2	-0.29	0.95271
3	0.15	0.95154
4	0.62	0.94657
5	0.08	0.94596

\*\*\* Significant at 1 percent level, \*\* Significant at 5 percent level, \* Significant at 10 percent level

**Table 5**  
**Cumulative Average Abnormal Returns (CAARs)**

<i>Days</i>	<i>CAAR (%)</i>	<i>p-value</i>
-10, 10	1.48	0.58347
-5, 0	0.47	0.11813
-3, 0	1.11	0.48540
-1, 0	0.35	0.36589
0, 3	0.46	0.52197
0, 4	1.08	0.17602
0, 5	1.16	0.18598

\*\*\* Significant at 1 percent level, \*\* Significant at 5 percent level, \* Significant at 10 percent level

Table 5 shows the cumulative average abnormal returns (CAARs) for multiple periods surrounding the announcement date. Overall, the CAARs yield similar results with the AARs. None of them are statistically significant. Based on the regression run for the market model, the average beta for the firms is 0.97. Therefore, it can be concluded that the firms which propose the issuance of private placements do not possess high market risk or systematic risk.

The insignificant results may be explained by the rule that one investor can only purchase two percent of the issued shares. Due to the small number of shares held, the investor will not be able to involve in any management decision. Consequently, private placement may result in managerial entrenchment instead of improving monitoring. The findings do not support the findings by Shiu and Wei (2013), Cheng et. al., (2014), and Yeh et. al., (2015) which provide evidence that the positive effect is due to the higher level of monitoring services and better corporate governance quality. Nevertheless, the results are not surprising because as revealed by Claessens et. al., (2002), Malaysian firms have high concentrated ownership. According to Carney and Child (2013), family's ownership in Malaysian firms on average constitutes more than 40 percent of the total shares. For that reason, the placement of only two percent new shares to one investor will not result in substantial effect to the firm's value. Definitely, the investors will have the limitation or not be able to actively involve in the firm's activities and operations. In brief, the changes in ownership following the private placements are so small. As a result, neither the firm's affairs nor the share prices are significantly affected. In a nutshell, the news is not convincing enough to create a significant pressure on the prices. Another possible argument is that firms time to issue new shares when they are overvalued. Nonetheless, investors will only purchase if they identify the shares as undervalued. Assuming that these investors are able to evaluate the firm's condition and performance, they will only purchase undervalued or fairly valued shares. Consequently, only fairly valued shares will be offered and no significant abnormal returns will be realized.

## 5. CONCLUSION

The purpose of this study is to investigate the possibility of an impact that equity private placement announcements have on shareholder wealth. Overall, the results of the study indicate insignificant stock price reaction to the announcements. In addition, the results also reveal no significant abnormal returns for the period preceding and following the announcement date. In particular, the findings appear to run contrary to the finding of majority past studies which show that there is a positive stock price reaction to the announcements of equity private placements. Nevertheless, the findings are consistent with our expectation that the announcement effect of equity private placements in Malaysia will be different from those reported in other countries.

While not ruling out other plausible possibilities, the evidence from this study suggests that the insignificant effect might be due to the two percent maximum shares rule. We attribute the finding to the inability of the new shareholders to provide monitoring service as expected. In other words, the issuance of new shares fail to increase monitoring service and provide better governance. This is because the rule obviously prevents the creation of blockholders who can act as effective monitors for the issuing firms. In addition, it seems like the investors are unable to certify that the shares issued are worth buying. Thus, overall, the market is indifferent to the announcement of private placement as it fails to bring any significant benefit to the firm and investors.

In brief, the results of this study indicate that both the information and monitoring hypotheses used to explain the positive announcement period return cannot be used to explain equity private placements in Malaysia. Instead, evidence suggests that managerial entrenchment may be able to explain the impact of Malaysian private placements. The reason is that a small number of shares only helps to strengthen the major shareholders or management's control of the firm. Hence, Malaysian firms should implement strategy to place the new shares to investors whom they can establish long-term strategic alliance in order to gain the benefits of issuing private placement.

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